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In The
Supreme Court of the United States

OCTOBER TERM, 1995

LOWSLEY-WILLIAMS AND COMPANIES, ET AL.,
PETITIONERS

v.

RAYTHEON COMPANY,
RESPONDENT

On Petition for a Writ of Certiorari to the
California Court of Appeal,
First Appellate District, Division Five

PETITIONERS' REPLY TO BRIEF IN OPPOSITION

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26 pp

RULE 29.6 LIST OF CORPORATE PARTIES' PARENT COMPANIES AND SUBSIDIARIES

Pursuant to Rule 29.6 of the Rules of the Supreme Court of the United States, a listing of parent and nonwholly owned subsidiaries of each of the corporate petitioners is set forth at App. 101a-111a of the Petition for a Writ of Certiorari.

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PETITIONERS' REPLY TO BRIEF IN OPPOSITION

The petition presents a fundamental due process question of whether a "bond or additional license" requirement, which Raytheon concedes to be "onerous" (R 902), can be imposed on insurers as a pre-condition to being allowed to defend themselves in litigation. An additional issue, disputed by Raytheon in its opposition, is whether issuance of policies in a manner that was consistent with the California Insurance Commissioner's interpretation and enforcement of California insurance requirements, and not inconsistent with any pre-existing California statute, regulation, or court decision, gave rise to a protectible property interest. Both are issues that lie at the heart of the Fourteenth Amendment and are appropriately before this Court.

I. THE COURT OF APPEAL'S OPINION HAS BEEN WIDELY CITED AND RELIED UPON BY OTHERS.

Raytheon previously argued that the Court of Appeal's opinion in this case should be published because "the constitutionality of Ins. Code § 1616 'involves a legal issue of continuing public interest...'." *See*, Raytheon's May 10, 1995 letter to Court of Appeal.

Despite the denial of Raytheon's request, the opinion repeatedly has been cited by other corporate policyholders that seek to use the pre-answer bond statutes in high-stakes pollution coverage litigation. The opinion has been cited by Lockheed in its $475 million pre-answer bond motion and by Exxon in its $850 million pre-answer bond motion. Even Raytheon's counsel have cited the opinion in other pollution coverage cases brought by them

on behalf of Tosco Corporation and Potlatch Corporation.

II. THE COURT OF APPEAL OPINION'S DEVASTATING IMPACT IS BROAD, AS IT AUTHORIZES USE OF THE PRE-ANSWER BOND TACTIC WHENEVER A MULTI-STATE RISK IS INVOLVED.

Before the Court of Appeal's opinion in this case, pre-answer bond statutes were rarely, if ever, used. Raytheon has never cited any California case applying the statute when the policies had been placed through a surplus line broker.[1/]

By 1984, when Raytheon hired Frank B. Hall of Massachusetts[2/] to obtain the involved insurance policies,[3/] and

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[1/] Although Raytheon suggests that "[t]he lower courts have consistently held such statutes to be constitutional," it cites no cases in support of that statement and appears to refer only to *Trihedron*, which involved no surplus line broker, and *Mid-American*.

[2/] The Court of Appeal found that Raytheon "hired" as its insurance broker Frank B. Hall of Massachusetts. (App. 12a) Under the Court of Appeal's analysis, a pre-answer bond is required because Raytheon selected a broker licensed in Massachusetts and chose to sue in California. Had Raytheon selected another Frank B. Hall subsidiary, Frank B. Hall of California, which was licensed in California (R 623, 701), or selected Massachusetts as the litigation forum, the onerous pre-answer bond requirement would not be available to Raytheon. This circumstance is what caused the trial court to question whether there was not "something wrong" and to comment that "usually the law makes sense." (R 903) It also relates to what the Court of Appeal dismissed as a "necessary evil of federalism" and "regulatory Balkanization." (App. 24a) In fact, the "evil" was created by the Court of Appeal's unexpected departure from the position of the California Department of Insurance -- and then its decision to ignore the position of the California Department of Insurance.

[3/] Raytheon complains that it does not have California Insurance Guarantee Association protection because Petitioners are not admitted insurers. Yet the Court of Appeal found that "the additional excess coverage requested by Raytheon was not available from insurers admitted to transact insurance in the State of

when those policies were negotiated and issued to Raytheon in its home state, Massachusetts, no California appellate court had ever applied the California pre-answer bond statutes -- despite the passage of 35 years since their enactment.

By 1993, when Raytheon made its pre-answer bond motion, only one California appellate court had addressed the application of the pre-answer bond statute. The statute was applied to require a bond from a rogue Caribbean insurer, which had illegally transacted insurance in California without the involvement of any surplus line broker. *See, Trihedron Internat. Assurance, Ltd. v. Superior Court*, 218 Cal. App. 3d 934, 267 Cal. Rptr. 418 (1990).

No California appellate opinion before the appellate opinion in this case had ever applied the pre-answer bond statutes to an insurance transaction, similar to the involved transactions, where the transaction conformed to all regulatory requirements of the California Department of Insurance. As the California Department of Insurance *amicus curiae* letter (reprinted as an attachment) notes, this case differs from the *Trihedron* case because it "involved no surplus line broker." (Reply App. 6a)

London Market insurers for decades have provided insurance to America's Fortune 500 companies, including companies identified in earlier briefs, such as Shell Oil, ARCO,

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State of Massachusetts." (App. 12a) Raytheon, through its agent, Hall, knew that it was not purchasing insurance from an admitted insurer and knew that it was not obtaining insurance protected by a state guarantee fund. Such insurance "was not available."

Texaco, Union Oil, Lockheed, Martin-Marietta and FMC Corporation. As virtually all Fortune 500 companies have multi-state operations, London Market insurers have operated in reliance on "the position of the [California] Department of Insurance, communicated to the industry, that a multi-state risk negotiated and placed outside of California under the authority of an insurance license issued by the state in which the placement is negotiated is not subject to California surplus line reporting requirements." (App. 33a-34a) Transactions involving billions of dollars of insurance premiums have been completed in reliance on this long-standing position of the California Department of Insurance and other state insurance departments.

Because the hard-fought pollution coverage litigation between Fortune 500 companies and their insurers involve long-expired multi-state risk insurance policies that were issued in the 1950s, 1960s, and 1970s in conformance with state insurance department positions regarding such transactions, the pre-answer bond statutes provide a tactic that has the potential to drive even the most solvent insurers to bankruptcy by requiring a forfeiture of the policyholder's premium payments to a surety and imposing a "freeze" of the insurers' assets as the result of surety collateral requirements.[4/] The ability to freeze assets has the potential of

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[4/] Within one month of the Texas Supreme Court's decision in *Mid-American Indemnity Ins. Co. v. King*, 38 Tex. Sup. Ct. J. 1018, 1995 WL 407388 (Tex. 1995), the insurer filed a bankruptcy petition, which stayed further proceedings in that action.

The Second and Seventh Circuit Courts of Appeal have recognized that bond requirements can have devastating financial effects. *Texaco Inc. v. Pennzoil*, 784 F.2d 1133, 1138 (2nd Cir. 1986) rev'd on other grounds, 481

creating a devastating "run-on-the-bank" financial failure.

III. THE CONSTITUTIONAL ISSUE WAS PRESERVED.

Raytheon argues that the constitutional issue was waived, yet the due process argument was raised in Petitioners' first brief filed in the trial court (R 429-436), and vigorously argued in every subsequent brief. The due process argument was never waived;[5/] indeed the Court of Appeal considered and rejected the argument. (App. 24a)

Petitioners also repeatedly asserted that these insurance transactions conformed to the requirements governing the placement of insurance (R 912; Writ Petition at pp. 25-27) and included that assertion in the "Issues Presented" in both petitions for review to the California Supreme Court. The Court of Appeal simply considered and rejected the argument. The fact that additional support from the California Insurance Commissioner was provided by the State's regulator after the Court of Appeal ruled that Petitioners should have "accounted themselves to the California Insurance Commissioner" (App. 21a) does not support any waiver argument, as Petitioners repeatedly had argued that the transaction had conformed to all applicable statutory requirements.

Finally, there was no waiver of the fundamental *Bell v.*

Dillion v. City of Chicago, 866 F.2d 902, 905 (7th Cir. 1988).

[5/] Petitioners did waive certain statutory interpretation issues about the scope of the pre-answer bond statutes, as the Court of Appeal noted in its opinion. (App. 17a-21a)

Burson argument, which was considered and rejected in the Court of Appeal's written opinion (App. 19a), with the statement that the argument had been "examined and rejected on our initial writ review." (App. 19a)

IV. PETITIONERS HAD A PROTECTIBLE PROPERTY INTEREST IN TRANSACTING SURPLUS LINE INSURANCE BUSINESS WITH RAYTHEON AND OTHER FORTUNE 500 COMPANIES.

Certain Underwriters at Lloyd's, London and London Market insurance companies for decades have provided insurance to America's Fortune 500 companies. Raytheon now questions whether, under the Fourteenth Amendment, Petitioners had a protectible interest in issuing insurance policies generating billions of dollars of insurance premiums in a manner that conformed to the position of the California Department of Insurance.

The California Insurance Commissioner, as confirmed by a letter brief in this action, previously had communicated to the industry that Petitioners were not required to be admitted California insurers. No statute, regulation, or California case law in existence at the time the policies were issued contradicted the Department's position. In fact, by statute, those Petitioners who are Lloyd's underwriters could not be admitted California insurers. Cal. Ins. Code § 699. And, as Raytheon acknowledges, admission is required under section 700(a) of the California Insurance Code only if Petitioners, at the time the policies were issued, transacted insurance "in this state."

Because surplus line requirements are merely an exception

to California's admission requirements set forth in section 700, the surplus line requirements logically would not apply to transactions not subject to section 700. This is confirmed by section 1761, which requires the involvement of a California-licensed surplus line broker only for transactions "within this state." At the time the policies were issued, the only acts encompassed within the section 35 statutory definition of "transact" occurred *outside* the state.[9] The California Court of Appeal specifically found that the insurance negotiations and the policy issuance occurred "outside the State of California." (App. 12a)

Petitioners justifiably relied on the statutory language and the Department of Insurance's communications to the industry to conclude that they had a right to issue the policies to Raytheon through Raytheon's Massachusetts-licensed broker.

V. THE COURT OF APPEAL'S RULING BELOW WAS AN UNFORESEEABLE DEPARTURE FROM THE EARLIER, CONSISTENT POSITION OF THE DEPARTMENT OF INSURANCE.

The policies at issue were lawfully placed in conformance with the statutory requirements as interpreted and enforced in 1984

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[9] Raytheon refers to another section, section 1611, which by its language is limited to defining, not the "transaction" of insurance that already was defined in section 35, but the acts that are deemed to constitute the appointment of the insurance commissioner as agent for service of process. No court prior to the issuance of the involved policies had ever referred to section 1611 as defining what constituted the transaction of insurance in California or had ever suggested that an out-of-state transaction would be considered a California transaction for purposes of regulating the negotiation and issuance of the policies simply because a corporate policyholder had some of its operations in California.

by the California Department of Insurance. Petitioners "negotiated and placed" a multi-state risk insurance policy "outside of California" through Raytheon's agent, Frank B. Hall & Co. of Massachusetts, Inc. ("Hall"), who acted "under the authority of" a Massachusetts surplus line broker's license. (App. 12a) The policies at issue conformed with the requirements imposed by the California Department of Insurance[7/] -- the only legal authority available to Petitioners at the time the policies were issued.

Petitioners were justified in relying on the California Department of Insurance's legal position. *See, United States v. Pennsylvania Indust. Chem. Corp.*, 411 U.S. 655, 674 (1973). And because the Department's position was consistent with the governing statutes and relied upon by the industry in issuing countless insurance policies to Fortune 500 companies, the Court of Appeal should have accorded great weight to the Department's position regarding the legality of the transaction. *See, Whitcomb Hotel, Inc. v. California Employment Commission*, 24 Cal. 2d 753, 756-57, 151 P.2d 233, 235 (1944).

Property interests are created by state law, but "federal

[7/] Furthermore, although Petitioners were precluded by operation of section 1616 from conducting formal discovery, Frank B. Hall (now known as Prometheus Funding Corp.) submitted a letter to the Court of Appeal shortly after the California Supreme Court transferred the case back to the Court of Appeal -- and long before the Court of Appeal's decision -- confirming that were formal discovery permitted, it "would demonstrate that [Frank B. Hall & Co. of Massachusetts] fully complied with the requirements of the surplus lines laws of Massachusetts ...." (Reply App. 9a) Raytheon's suggestion that review of this issue can only occur on "a fully developed factual record" would permit the continued existence of a constitutional defect incapable of review since plaintiffs request pre-answer bonds before any responsive pleading has been filed or discovery has been permitted.

constitutional law determines whether that interest rises to a level of a 'legitimate claim of entitlement' protected by the Due Process Clause." *Memphis Light, Gas & Water Div. v. Craft*, 436 U.S. 1, 9 (1978) (citations omitted). The California Department of Insurance, through its communications to the industry, created a protectible property interest for insurers, like Petitioners, who conformed to the Department's position on multi-state risk insurance. The Court of Appeal's opinion below was an unforeseeable retraction of this property interest. In addressing the federal constitutional issue, "it is the province of this Court to inquire whether the decision of the state court rests upon a fair or substantial basis." *Demorest v. City Bank Farmers Trust Co.*, 321 U.S. 36, 42 (1944). As Hart and Wechsler plainly imply, this Court should not consider itself bound by a state court's determination if it is "so aberrational or surprising that it subverts the purpose of the constitutional guarantee." *Hart and Wechsler's The Federal Courts and the Federal System* 579 (3d ed. 1988). As Raytheon points to no pre-1984 statute, regulation or court decision suggesting that Petitioners could not rely on the regulatory position of the California Department of Insurance, the record amply supports a determination that there was a property interest protectible under the Fourteenth Amendment.[9/]

[9/] Despite having blocked discovery and any hearing on the merits in the trial court, Raytheon now suggests that its claim might be covered because another insurer settled with Raytheon. But Raytheon ignores the pollution exclusions that operate to bar coverage. It also fails to describe that Continental settled to obtain a release not just of the 1984-1985 policies, but of 19 policies, which had liability limits in the aggregate many times the amount Continental paid.

CONCLUSION

This Court's *Bell v. Burson* holding compels the conclusion that when an insurer has issued an insurance policy in conformance with the regulatory requirements enforced by state regulators, the onerous "bond or additional license" requirement cannot subsequently be imposed as a pre-condition to the right to defend based on the mere fact that a claim has been made, without any inquiry into the merits of the claim.

The petition places before this Court the constitutionality of the pre-answer bond statutes that represent a devastating threat to Petitioners, to the eight-billion-dollar-per-year surplus line insurance market, and to the policyholders that have relied on the surplus line insurance market for both the payment of covered claims and the fulfillment of current insurance needs.

Respectfully submitted,

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California Department of Insurance Amicus Letter Brief 1a

APPENDIX B

Prometheus Funding Corp. (f.k.a. Frank B. Hall & Co., Inc.) Amicus Letter 8a

APPENDIX A

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May 10, 1995

Honorable J. Clinton Peterson, Presiding Justice
California Court of Appeal
First Appellate District, Division Five
Marathon Plaza, South Tower, Suite 600
303 Second Street
San Francisco, CA 94107-1369

RE: *Lowsley-Williams and Companies v. Superior Court (Raytheon Corporation)*
Court of Appeal, First Appellate Dist., Division Five
No. A063833,
San Francisco Superior Court No. 950755
Application of the California Department of Insurance For Leave To File Amicus Curiae Letter Brief In Support Of Petition For Rehearing; Brief

Dear Honorable Justice Peterson:

The California Department of Insurance requests leave to file an amicus curiae letter brief in this case in support of the petition for rehearing of petitioners Lowsley-Williams and Companies.

The Department of Insurance is familiar with the questions involved in this case and the scope of their presentation and believes that there is a necessity for additional argument on the following point: the legality of the placement of insurance on California property wherein the transaction took place in Massachusetts, with the insured being a Delaware corporation with its principal place of business in Massachusetts, having multi-state operations including the property in California, and the placement being made by a Massachusetts licensed surplus line broker using insurers not admitted in California.

The Department of Insurance believes that its input would be valuable to this Court because it is charged with the enforcement of the California Insurance Code, including regulating surplus line brokers in California (Insurance Code §§ 1760, et seq.). Inasmuch as the Department has been informed that the petitioners will be filing a petition for rehearing, the Department of Insurance hereby seeks permission to file a short letter brief as amicus curiae in the form as attached hereto.

Sincerely,

/s/

RICHARD F. FINN
Supervising Deputy
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Attachment

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May 10, 1995

Honorable J. Clinton Peterson
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RE: *Lowsley-Williams and Companies v. Superior Court (Raytheon Corporation)*
Court of Appeal, First Appellate District, Division Five
No. A063833, San Francisco Superior Court No. 950755
Amicus Curiae Letter Brief In Support Of Petition For Rehearing

Dear Honorable Justice Peterson and Associate Justices:

This letter is respectfully submitted on behalf of the California Department of Insurance.

On April 25, 1995, this Court issued its decision in this

matter relating to provisions of the California Insurance Code. The issues concern the placement of insurance on California property owned by Raytheon. Raytheon, a Delaware corporation with its principal place of business in Massachusetts, transacted in Massachusetts with a Massachusetts licensed surplus line broker (not licensed in California) to obtain excess policy coverage on the California property with companies that are not admitted by the State of California to transact insurance within this state. The Court of Appeal decision (on page 12), determined that such insurance was "illegal." The California Department of Insurance, as amicus curiae, would like to address only this one point.

The Department of Insurance will specifically address that portion of the Court's decision beginning at page twelve, line nine, the sentence that opens with the word "furthermore":

> "Furthermore, the issuance of the policies in the present case is just as "illegal" as in *Trihedron*. By "illegal," Companies mean the policies were issued to California insureds by a nonadmitted insurer. That is exactly the case herein. Companies maintain that the case is different because they did not issue the policies directly but through a surplus line broker. Companies are correct that in general a nonadmitted insurer may issue insurance to California insureds without certification *if it does so through a bona fide, California licensed surplus line broker.* Companies are incorrect when they argue that by using a foreign broker not licensed in California, it may insure California persons or business operations without being admitted. Companies'

> position would allow such insurance to be issued with no regulatory oversight by this state, either by means of the admission process or by the licensing regulation of surplus line brokers." (This reference also includes footnote 12.)

In agreeing with and applying the law as set forth by the Fourth District Court of Appeal in *Trihedron Intern v. Superior Court* (1990) 218 Cal.App.3d 934, 267 Cal.Rptr. 418, this Court finds that there was a "California insurance transaction", as defined in *Trihedron* and Insurance Code section 1611, and that the "illegal" transaction of insurance has occurred. No citations are given for the conclusion that the transaction of insurance was "illegal" under the particular facts of this case, nor are any citations given for the conclusion that the transaction in this case may only issue "through a bona fide, California surplus line broker."

Amicus curiae Department of Insurance submits that the conclusion that the transaction was illegal unless through a California surplus line broker is in error. Insurance Code section 1761 provides in relevant part as follows:

> "Except as provided in sections 1760 and 1760.5, a person within this State shall not transact any insurance on property located ... within ... this State with nonadmitted insurers, except by and through a surplus line broker licensed under this chapter and upon the terms and conditions prescribed in this chapter."

It is the position of the Department of Insurance, communicated to the industry, that a multi-state risk negotiated and

placed outside of California under the authority of an insurance license issued by the state in which the placement is negotiated is not subject to California surplus line reporting requirements. The Department does not believe the multi-state risk placement involved in this case, which was negotiated in Massachusetts by a Delaware corporation (with its principal place of business in Massachusetts) and a Massachusetts-licensed surplus line broker, to be illegal under California law. This position has no conflict with the *Trihedron* decision, which involved no surplus line broker. However, this Court's "illegality" discussion appears to be in conflict with the Department of Insurance's position and could cause significant confusion in the industry should the decision become disseminated. That "illegality" discussion (the first full paragraph, including footnote 12, on page 12 of the slip opinion) is not necessary in reaching this Court's holding that a bond was required under Insurance Code section 1616.

For the foregoing reasons, it is requested that the petition for rehearing be granted or the opinion be modified to delete any reference to the transaction of insurance in this case having been "illegal".

DATED: May 10, 1995.

Respectfully submitted,

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/s/

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APPENDIX B

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August 16, 1994

To The Honorable Justices of the Court of Appeal of the State of California First Appellate District -- Division Five

RE: Lowsley-Williams v. San Francisco Superior Court
Raytheon Company, Real Party in Interest
A063833 San Francisco Superior Court No. 950755

Your Honors:

Prometheus Funding Corp. was formerly known as Frank B. Hall & Co. Inc., an international insurance services firm ("Frank B. Hall"). During the 1980's, Frank B. Hall's subsidiary, Frank B. Hall & Co. of Massachusetts, Inc. ("Hall/Massachusetts") acted as insurance broker for Raytheon. Hall/Massachusetts was merged into Frank B. Hall Insurance Brokers, Inc. in 1990 and the

operating assets of that company were sold to Aon Corp as of November 2, 1992. Frank B. Hall Insurance Brokers, Inc. is a subsidiary of Prometheus Funding Corp. and I am senior Vice President and Assistant Secretary of that company.

I have been informed that questions have arisen in this action regarding 1984-1985 insurance coverage placed by Hall/Massachusetts for Raytheon with Defendants Certain Underwriters at Lloyd's, London and London Market Insurance Companies ("London Insurance Defendants"). This letter will confirm that at the time this coverage was placed, Hall/Massachusetts was duly licensed as a surplus lines broker. This letter will also confirm that, if discovery were permitted, the discovery responses would demonstrate that Hall/Massachusetts fully complied with the requirements of the surplus lines laws of Massachusetts and that the appropriate surplus lines taxes were paid on the coverages placed with the London Insurance Defendants.

Respectfully submitted,

Peter J. Dranginis, Jr.

PJD/ae
L:Raytheon